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The Woman CPA

is having an

Identity Crisis

Returning the questionnaire
on pages 15 and 16
will help resolve it.

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CONTENTS

Cover illustration by Jo Ellen McElwee

Editor's Notes

Some speculation on houses —

Houses in a row; the mansion on the hill; villas by the sea and rose-covered cottages; a gingerbread house for the children; the House of Hapsburgs, of Tudors, or Windsors; a house built upon the sands; the Houses of Parliament, and the house of God — over time and cultures houses have been many things to humankind.

In many cases a house is far more than a structure of wood or brick and cement. Accountants, like all professionals, recognize the code of ethics that unites them. Pressure of their house of peers is readily acknowledged; more than that, peer review is invited by accountants in public practice.

When the congressional committee chaired by the late Senator Lee Metcalf produced a staff study critical of the "accounting establishment" the profession reacted very defensively in the same reflex pattern as an endangered household. Resident speakers and writers declared, almost in unison, that the accounting profession would set its house in order.

The concept of *house* is as useful to literature as moon and June are to love songs. Everyone understands the intertwining of emotional shelter with the physical shelter that we call home. Motel rooms are not the same at all. We also understand the power inherent in a large household, a strong family; the actor and actress respond to a "good house;" the full house is dear to both poker player and parent.

Moralists and preachers would be much less persuasive if denied reference to a variety of distressed houses. Their arguments might be as flimsy as a house of cards, for instance. Fortunately for the picturesque quality of our everyday conversation, at least in its serious moments, we enjoy a biblical legacy of the house that "was founded upon a rock," and "the foolish man who built his house upon the sands." Once upon a time children were expected to learn some of the eloquence and imagery of which language is capable. It was also presumed that a small homily could do no harm and so "The Chambered Nautilus" by Oliver Wendell Holmes was part of the syllabus for early reading. The nautilus builds ever more spacious rooms for itself, small chamber opening to larger chamber, so that the record of a lifetime expands in spiraling lustre. "Build thee more stately mansions, O my soul," exhorted Holmes. "As the swift seasons roll! Leave thy low-vaulted past!"

Nautilus shells, like houses, are more commonly thought of as coverings, and for the mortal form, not the soul, but both have a way of revealing the inhabitant. It isn't necessary to live in a glass house either, to be revealed, and certainly it is imprudent to throw stones because most of us admit that at least one wall of our own house is transparent to the eyes of the world. Meanwhile, the well tended house and yard tell something of the owner, as does the highly fashionable address, or the isolated rural location. If an observer gets past the threshold the personality of the owner is fully displayed but if the interior remains secret to the world, that itself implies something suspect or sinister about the occupant.

One of the truest memoirs of a collective culture is the house of God, or of the gods. In the central square, the Zocalo, at Mexico City ancient Indians built their altars but they have been replaced by Roman Catholic architecture. Southeast of Mexico City is the little town of Cholula where successive tribes of Aztecs built a second large pyramid all the way around the first pyramid, then that one, too, was enveloped by an even larger pyramid. To date archeologists have uncovered six successive walls. Accounting also has its layer upon layer structure, making a formal start with the Committee on Accounting Procedure in 1938, expanding through many corridors of thought with various research and study groups to the elaborate edifice of standards built by the Accounting Principles Board, which is superseded in many places by the accounting structure-in-progress of the Financial Accounting Standards Board. At times the minutely detailed and rearranged accounting standards have almost taken on the appearance of the Winchester house in San Jose that has stairs that lead to a blank wall, and doors that open into nothing. The owner of that house was deluded in the belief that as long as she kept on building something, anything, she would survive.

When the accounting profession responded to government criticism in the Metcalf Committee report one of the moves to set its house in order was the separation of public accounting practitioners into the two groups known as the private companies practice section, and the SEC practice section. A cry went up immediately that a "house divided against itself shall not stand," which is more of the biblical legacy, but duality in the profession relates to clientele, not to purpose, and the house of accounting has been standing firmly for three years since the division.

The Woman CPA is itself a house that reflects its readers and to best serve those interests we must have up-to-date information as to who our readers are, and what they are doing. Please help by attending to the questionnaire on pages 15 and 16. We are culturally removed from the elegance of the chambered nautilus but we do aspire to a journalistic house that is appropriate to the fine professionals we serve.

Constance T. Barcelona

Investment Credit For Property Acquired With Lease Financing

The Lessee As De Facto Purchaser

by Howard Godfrey

In 1980, corporations were expected to save $16 billion as a result of the investment credit, leaving net income taxes of $71 billion.[1] The investment credit can be an important step in reducing income taxes, provided the taxpayer meets the detailed requirements of the law.

The credit may be claimed when a taxpayer purchases or leases qualifying property. The law related to the credit is far more restrictive for property used under a lease arrangement than for property that is purchased. The benefit of the credit may be partially or totally lost if the restrictions are not given adequate consideration. However, if a lease has certain characteristics, the lessee is treated as a purchaser of the property and the restrictions on investment credit for leased property are inapplicable. Some of the problems associated with the investment credit for leased property are discussed in the article.

Property Qualifying for the Investment Credit

The Internal Revenue Code provides the investment credit for certain property having a useful life of at least three years. The credit applies only to property on which the taxpayer is allowed depreciation, or amortization in lieu of depreciation. Finally, the credit is limited to: (1) tangible personal property, (2) certain other tangible property not including buildings and their structural components, (3) certain elevators and escalators, (4) certain agricultural or horticultural structures, and (5) some building rehabilitation expenditures.[2]

A close reading of the preceding paragraph suggests that a lessee is not allowed any credit on leased property, because the lessee is not allowed to depreciate such property. However, there is an exception to the general rule that allows a lessor to treat the lessee as purchaser of the property.[3] The lessor may elect to pass part or all of the credit to the lessee.[4] This election provides flexibility so the credit can be made available to the party who can get the most benefit from it.[5]

Limitations on Pass Through of Credit

Two provisions limit the credit which a lessee can obtain by leasing property. First, the credit can be passed to the lessee only if the property is new section 38 property.[6] Second, in computing the credit the lessee uses the life which the lessor uses for depreciation purposes.[7] The impact of the second limitation can be explained with the following:

New equipment costing $12,000 is acquired by a leasing company and immediately leased to ABC Company for five years, with ABC Company given the option to purchase the equipment at the end of the lease. The lessor elects to pass the investment credit to the lessee. The equipment has a service life of ten years. The lessor will dispose of the property at the end of the lease, either through exercise of the purchase option by the lessee, or by regular sale of the equipment. In computing depreciation, the lessor will use an estimated life of five years. ABC plans to exercise the option and continue using the property for an additional five years.

In this example, even though ABC Company plans to use the property for ten years, it must use a five year life in computing the credit.

The limitation on the life of the property is important. The total cost of property qualifies for the investment credit only if the property has an estimated life of at least seven years. Only two-thirds of the cost of the property qualifies if the life is five or six years. The fraction is one-third if the life is three or four years.[8] In the example above, the use of a five year life by the lessor limits the lessee's qualifying property to two-thirds of its cost. Thus, ABC Company claims the credit only on a cost of $8,000. The other $4,000 investment does not qualify for the credit.[9]

Purchase of Leased Property by Lessee

Variations in Amount of Credit Passed Through—The credit claimed by a lessee will vary depending on the circumstances. If the lessor elects to pass the credit through to the lessee and uses a depreciable life of seven years or more, the lessee may get full benefit of the credit.[10] If the lessor uses a depreciable life of six years or less, the lessee's credit will be limited as described above. If the lessor elects to retain the credit, none of the credit will be available for the lessee. In either of these situations, a taxpayer who leases property and subsequently purchases that property needs to know the tax consequences of the purchase.

The substance of a contract, rather than its form, is the basis of tax law related to leases.

New Section 38 Property—The statute allows the credit on new section 38 property placed in service by the taxpayer during the year. Assume a lessee of new property fails to get the full benefit of the investment credit either because of the limitation related to the property's depreciable life to the lessor, or because of the lessor's failure to pass the credit to the lessee. Assume also that the lessee exercises an option to purchase the property within a short time after entering into the lease agreement. The lessee would seem to be placing in service new section 38 property, particularly if the lessee begins using the property and exercises the option in the same year.

The Internal Revenue Service was asked for advice about a case in which a taxpayer leased new section 38 property, properly received the pass through of investment credit, and later purchased the property from the lessor. According to the IRS the lessee is treated as the purchaser only for purposes of section 48(d) which permits the pass through of the investment credit. For other purposes, the lessor is considered the purchaser and original user. "In the instant case, the original use of the property commences with the lessor in its leasing operations. Therefore, since the original use did not commence with the taxpayer, the property is not 'new section 38 property' when purchased and placed in service by the taxpayer."[11] The result would be the same whether the equipment is purchased in the same year in which the credit is passed to the lessee or in a subsequent year.

Used Section 38 Property—Subject to certain limitations, the investment credit is allowed for used section 38 property placed in service. However, the exercise of a purchase option by a lessee is not considered an acquisition of used section 38 property. According to the regulation: ". . . where the lessee has been leasing property and subsequently purchases it (whether or not the lease contains an option to purchase), such property is not used section 38 property with respect to the purchaser because the property is being used by the same person who used it before acquisition."[12] This causes harsh consequences where a lessor retains the credit, and later the credit is fully recaptured because of early disposition of the section 38 property. In such case, the benefit of the credit is not enjoyed by either the lessor or the lessee.

Tax Court Support of IRS Position—The Tax Court recently supported an IRS interpretation of the statute.[13] In the years 1971 through 1973, a taxpayer entered into rental agreements for four items of equipment to be used in the taxpayer's construction business. The investment credit was not passed to the lessee. In 1972 and 1973, the taxpayer elected to purchase all four items. Two of the items were rented and then purchased in the same tax year. The taxpayer claimed the credit on all four items. The IRS conceded that the equipment was section 38 property. The taxpayer conceded that the equipment was not used section 38 property, because of the regulation cited above. The taxpayer contended that the property was new when he first used it, so he should be considered to have placed in service new section 38 property. The Tax Court agreed with the Commissioner that the lessor, not the lessee, placed the property in service. Thus, the lessee was not entitled to any investment credit as a result of purchasing the equipment.

Lease vs. Installment Purchase

In the ABC Company example presented earlier, the lessee claims a limited amount of investment credit at inception of the lease, and receives no additional credit when the purchase option is later exercised. Taxpayers in similar circumstances may be happy to get some credit, even though it is less than would be available if the property were initially purchased rather than leased. After all, these taxpayers receive a credit without actually acquiring depreciable property. Closer analysis may reveal that this is an inaccurate view of the situation. Assume the contract is noncancellable and the option price is nominal in relation to the expected value of the property at the expiration of the lease. In that case, the leased property will be reported in the financial statements as an asset because the accountant views the contract as an installment purchase.[14] Does this viewpoint of the transaction also apply for tax purposes? The answer to this question is best seen by tracing the deelopment of some legal concepts related to leases.

Judicial and Legislative Attention to Substance Over Form

Supreme Court Decision on Lease Contract—In 1876, the U.S. Supreme Court was called upon to decide whether a particular lease arrangement was in reality a lease or a sale of property. Illinois law provided that a vendor could retain a lien on property only by recording the lien in accordance with the Chattel Mortgage Act. Conant and Company obtained the use of a locomotive engine through a lease arrangement. The lease contract required payment of rent totaling $12,093.96 over a period of one year. After making the last rent payment, Conant and Company was to receive title to the engine. The lessor did not record a lien on the property. During the term of the lease the engine was sold by a court to satisfy creditors of Conant and Company. The lessor claimed that the engine could not be sold in this manner because Conant and Company was a lessee, not a purchaser. The Supreme Court stated: "Courts will always look to the purpose to be attained by the contract rather than the name given to it by the parties in order to determine its real character."[15] The court then ruled that Conant and Company had actually bought the engine. The vendor had failed to comply with the Illinois Chattel Mortgage Act. Thus, the sale of the engine to satisfy creditors of Conant and Company was appropriate. This policy of considering the substance of a contract rather than its form was the basis for later development of tax law related to leases.

Early Income Tax Law—Beginning with the Revenue Act of 1913, the law has provided that taxpayers may deduct depreciation on business property in computing taxable income. This act also allowed deductions for "... rentals or other payments required to be made as a condition to the continued use or possession of property."[16] At that time the law did not explicitly recognize the problem of taxpayers purchasing property through lease financing agreements. With the 1916 Revenue Act, Congress revised the sentence to read "... rentals or other payments required to be made as a condition to the continued use or possession of property *to which the corporation has not taken or is not taking title, or in which it has no equity.*" [Emphasis added][17] Where rental payments are large enough to build up equity in the leased property, the government can require the taxpayer to capitalize the asset and deduct depreciation and interest rather than lease payments. This reclassification may increase taxable income in the early years of the lease contract.

Decision of Board of Tax Appeals—The Board of Tax Appeals considered a case involving the lease vs. purchase question in 1928.[18] The taxpayer had entered into a lease contract in 1921 for some machines having a value of $26,650 at the inception of the lease. The taxpayer made rental payments of $24,000 over the thirty month lease, and then exercised the option to buy the property for $5,677.26. Although the lease term was only thirty months the lessee was using the machines five years after entering into the lease cotract. The Board of Tax Appeals disallowed the deduction of lease payments because the lessee was building equity in the leased property. For decades, guidance in classifying lease contracts as leases or purchases was found in case law.

Original IRS Guidelines for Classification of Leases—In 1955, the IRS issued a revenue ruling containing guidelines for determining whether a contract is acutally a lease or an installment purchase.[19] The ruling draws heavily from a number of court cases involving the controversy. Among the characteristics suggesting that a contract is an installment purchase are:

1. rental payments materially exceeding fair rental property,
2. transfer of title upon payment of all rental payments required by contract,
3. an otion price which is nominal in relation to the expected value of theproperty at expiration of the lease, and
4. rental payments and an option price which together approximate
   (1) the price at which the property could have been purchased plus.
   (2) interest or carrying charges.

When a taxpayer leases property with a contract containing one of these provisions, the IRS may require the taxpayer to capitalize and depreciate the property. The introduction of the investment credit in 1962 added to the significance of deciding whether a contract is a lease or a purchase. This is seen in a quote from a decision of the Tenth Circuit Court of Appeals: "... the person who has the depreciable interest is the one who can claim the credit."[20] Before enactment of the credit, taxpayers frequently preferred to view the agreements as leases where the lease payments exceeded depreciation and interest in the early years of the contracts. Now, taxpayers often find it desirable to structure leases so that they have depreciation and interest deductions, and the investment credit as well.

IRS Clarifies the Tax Consequences

In 1972, the IRS issued a ruling that explained the tax treatment of a transfer of section 38 property under a lease arrangement which is in substance a sale of personal property.[21] The rents received by the lessor are actually payments of part of the sales price and interest. Gain on the sale is recognized subject to the provisions of sections 1231 and 1245 of the Code. The transaction is a disposition of section 38 property, thus subjecting the lessor to possible recapture of investment credit. The lessee is not entitled to a deduction of the rental payments, but is allowed deductions for depreciation and interest. The lessee can also deduct taxes and other costs associated with the ownership and use of the property. In addition, the lessee is considered to have purchased used section 38 property, and is entitled to claim the investment credit.

"... the person who has the depreciable interest is the one who can claim the credit."

The reader will recall that provisions of the law relative to pass through of investment credit to the lessee require that (1) the property be new, and (2) the useful life for computation of qualifying property be the useful life to the lessor. However, in the example described in this revenue ruling, the lessor is not passing the credit through to the lessee. The lessee has actually purchased the property and is entitled to the credit regardless of the actions of the lessor. So, the lessee gets the investment credit even though the property is not new. In addition, the useful life for purposes of computing the credit is the useful life to the lessee rather than the useful life to the lessor.

Summary

In a lease transaction, the investment credit on the leased property may be passed from the lessor to the lessee provided two conditions are met. First, the lease property must be new section 38 property. Second, the lessee must use the property's useful life to the lessor in computing the investment credit. The second condition prevents the lessee from getting maximum possible investment credit in certain cases. A lessee cannot get additional investment credit by purchasing leased property after being denied the credit because of lessor's failure to pass the credit through or because of the limitation related to lessor's useful life.

However, as this article has demonstrated, statutory law, case law, and revenue rulings support the view that certain types of leases should be accounted for as installment purchases of property. With these leases, the credit is available to the lessee whether the property is new or used, and the credi on the leased property is computed based on the useful life to the lessee. Also, the credit to the lessee is not contingent on the lessor electing to pass the credit through.Ω

NOTES

[1]*Special Analysis: Budget of the United States Government — Fiscal Year 1980.* Office of Management and Budget, pp. 208, 209.

[2]Internal Revenue Code, Section 48(a) (1).

[3]I.R.C., Section 48(d) (1).

[4]Usually, the lessee is considered to have acquired all of the leased property if the lessor elects to pass thecredit to the lessee. In this case, the credit will be available only to the lessee. If the lessor does not elect to pass the credit to the lessee, the credit will be available only to the lessor. However, a special rule applies to short-term leases, i.e. leases which: (1) are not net leases, (2) have a term less than 80 percent of the life of the leased property, and (3) apply to property having a class life in excess of e4 years. With a short-term lease for which a pass-through election is made, the lessor is treated as having acquired part of the property and the lessee is treated as having acquired the remainder. In this case, the credit is divided between the lessor and the lessee. See Sec. 48(d) (2).

[5]The focus of this article is the application of the investment credit in situations involving leased property. The maximum credit which can be claimed for 1980 is $25,000 plus seventy percent of the liability in excess of $25,000. These and other limitations not uniquely applicable to leasing are generally ignored in this article. Also, problems associated with noncorporate lessors, short-term leases and some other leasing situations are beyond the scope of this article. Finally, the detailed reporting requirements which must be met by lessor and lessee in order to elect pass-through of the credit from this article.

[6]Investment credit is allowed on used section 38 property purchased by a taxpayer. The amount of such property used in the computation of qualified investment is limited to $100,000 per year. However, the leasing of used property does not qualify the lessee for pass-through of the investment credit.

[7]I.R.C., Section 48(d) (3).

[8]I.R.C., Section 46(c) (2).

[9]If this case involved a five year lease and a ten year useful life to the lessor, the lessee would get the full benefit of the credit. Later exercise of the purchase option would not be a disposition of section 38 property and therefore would not require recapture of the investment credit. However, failure to exercise the purchase option would result in recomputation of investment credit based on five-year life, with the difference between the recomuted amount and the amount originally claimed being recaptured. See Reg. 1.47-2(b) (2) (iii).

[10]The lessee will not get full benefit of the available credit if the lease is a short-term lease. See footnote no. 4.

[11]Rev. Rul. 74-1, 1974-1, CB 5.

[12]Reg. 1.48-3.

[13]Haddock v. Commissioner, 70 TC No. 50.

[14]Professional Standards — Volume 3 (Chicago: Commerce Clearning House, Inc.), para. 4053.007.

[15]Hervey v. Rhode Island Locomotive Works, 93 U.S. 664 (1876).

[16]J. S. Seidman, *Seidman's Legislative History of Federal Income Tax Laws, 1938-1961*, (New York: Prentice Hall, Inc.), p. 992.

[17]Ibid, p. 961.

[18]Holeproof Hosiery Co. v. Commissioner, 11 B.T.A. 547.

[19]Rev. Rul. 55-540, 1955-2 CB 39.

[20]Lockhart Leaeing Co. v. U.S., 71-1 USTC

[21]Rev. Rul. 72-408, 1972-2 CB 86.

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Housing For New Life Styles

Risks And Rewards In Real Estate Investment

by Patricia Shannon

Gold, silver, equities, money-market deposits, bonds, fine art, antiques, precious gems, real estate: the accounting profession is forced to give serious consideration to an eclectic group of investments. Personal estate growth, or simply capital maintenance — the "staying even" concept — is more problematical, day by day. Accountant-client relationships are bettered when the accountant can knowledgeably discuss current market trends while leading up to ethical referral of the client to expert investment counsel, or in the case of real estate to a Realtor®. Alertness to changing conditions also awakens the accountant to opportunities for personal risks and rewards.

During the period of 1977-79, and even earlier, there was constant attention by the information media to the recession. Yes, it did finally occur in late 1979, but there was much growth in many investment areas, and especially in real estate, during the 1977-79 period. Of course scare tactics sell books, but do scare tactics make individuals so apprehensive that they avoid taking calculated risks that may furnish better returns on money? It should be remembered that calculated risk differs from person to person, according to nervous structure, age, and conditioning. Knowledge can make calculated risk manageable, not only for oneself but for one's client.

One of the ironic bits of information gleaned from stock investing in the late 1920s was that many people put their life savings into a "sure thing" without even knowing the product that their dollars would help produce, or how it would fit into the nation's economic picture. Today, even more extensive knowledge is needed as America's economic structure is increasingly affected by world-wide events. Regardless of what investment pattern is considered, action should be delayed until the base knowledge is perfected, and it often will be necessary, or at least consistent, to allot time for the continuation of knowledge. No longer can the acquisition of any profitable investment be tucked away in the back of the mind, once the purchase is made. When times change, investment patterns must also change.

It makes no difference whether investment is in the equity market, in diamonds, gold, fine arts, real estate, or some combination of these; the winnings will accrue to the knowledgeable. Along with keeping up-to-date in knowledge the investor must practice patience, and renounce greed. Patience concedes the golden opportunity lost and even though there may be a lump in the throat the mourner is consoled by the information gained in experience. Renunciation of greed affords release from sleepless nights that mark the plotting and panting after the highest possible profit.

Real estate has been one of the most talked about investments in the past few years. Everyone knows someone who has doubled or tripled money invested in a home or income property. Losses in real estate have been anomolous, atypical. What is of interest is whether the booming real estate market will continue. This article limits itself in scope to residential real estate, whether acquired for personal use or for the production of income.

Will residential real estate be a good investment in the decade of the eighties? What are the advantages, and the disadvantages?

Advantages

The good earth with the dwelling thereon represent a tangible investment, which economists advise holding in times of monetary instability. Ownership gives emotional satisfaction . . . doesn't everyone talk about "my home", or "my apartment house"? And certainly many, many more of those owners are female since the easing of credit restrictions for women. The potential for capital gains is there, and as long as income tax laws continue to favor real estate possession it makes an excellent tax shelter.

Disadvantages

Real property is a tangible asset, but unlike gold or fine art it demands constant maintenance and updating. Also, it does not have mobility nor does it have instant liquidity. It has a way of subtly tying itself into the heart strings of the owner so that there is too heavy an emotional entanglement when it comes time to sell. And, of course, the bubble in real estate values could burst. Further, there could be adverse changes in income tax laws concerning depreciation deductions and capital gains taxability. While tax changes seem unlikely they do depend on the political climate.

Advantages

When economists speak of the stability of real estate in times of an unsettled economy they are speaking in relatives, not in absolutes. A good piece of property may, indeed, shrink in value during economic

> The three most important words in real estate appraisal are location, location and location.

crisis but rarely would it become valueless, as has happened to money more than once during troubled periods in the world's history.

Real estate purchases in the traditional mortgage pattern may be thought of as similar to the purchase of stock on margin. Neither transaction requires the full purchase price at its inception and, assuming that the price of the stock does not decline below its market value at acquisition date, the main difference in full payment for real estate versus margin stock is one of time. However, the recent recession and concurrent high interest rates have given lending institutions an incentive for a break in traditional mortgage patterns. There is more and more talk of roll-over interest rates, variable interest rates, longer mortgage life, and the sharing of resale profits with the lending organization. These changes, in themselves, do not necessarily paint an unfavorable picture for the investor.

Current literature of the doomsaying variety points out that real estate, like all established values, is vulnerable to sociological crisis. However, a perceptive suggested hedge is real estate investment away from hugh metropolitan sectors. Urban concentrations have great susceptibility to civil unrest and population shift, which result in the erosion of substantial tax bases and a ripple effect in the downgrading of real estate values. Admittedly, the metropolis has both cultural and business opportunities that residents may regret leaving but there is infinite potential for the good life in large towns, or the smaller cities.

To build on the thought above, the three most important words in real estate appraisal are location, location and location. Location, wherever it is, has to mean more than status. It must mean good schools, a good police department, good fire protection, and an adequate tax base to furnish those and other desired services in the future. The knowledgeable investor must chose a location that is close enough for frequent review, both as to the immediate environs and as to overall changes in the community. Even within large metropolitan areas there are suburbs that have all of the desirable service and tax base qualities. Paradoxically, the inner-city has been pooh-poohed by many but the same inner-city is considered by other well qualified investment analysts to contain the biggest potential for real estate profits, especially if energy costs continue to escalate.

In these days of so-called personality fragmentation, real estate does warm the heart and does identify the owner as a settled person. Conservative employers look positively at the home owner as having greater stability and less mobility. In fact, many corporations encourage employee home ownership and try to minimize owner distress at time of transfer to another community. Such corporations are clients of a fast growing industry, called "third party" relocation management firms. Typical of the new industry are Merrill Lynch Relocation Management, Inc., and Employee Transfer Corporation, both of whom will buy an employee's home at fair market value and then resell it.

There is abundant evidence of the heart warmed by the possession of real estate. In conversation one often hear's a person speak of *my home*, or *my apartment house*. Rarely does one hear an individual speak fondly of *my A.T.&T. stock*. Emotional attachment is a big factor in the continuing rise in real estate prices. And, as noted earlier, women who would never have considered ownership as short a time as five years ago are entering the market now, and becoming real estate owners either on a personal basis or an investors.

Tax Benefits

The rosy glow of home ownership should not for one minute distract the owner from the potential for capital gains. Income tax laws favor both home ownership, and/or ownership of rental income property, and the ultimate sale of such properties. Of course expenditures for property taxes and mortgage interest are deductible from the tax base, and for the home-owner tax laws offer exclusion from capital gains tax as long as another home, like or better, is purchased, and the additional forgiveness for over-55 owners of $100,000 capital gains on a one-time only basis. Income property owners enjoy liberal depreciation allowances on investment property and tax shelter inherent in income property is best realized with the utilization of some form of accelerated depreciation. The corollary to rapid write-off is then a prompt resale of the property. Most investors in income property are so imbued with the short-term concept that they buy with the assumption of resale in five years or less.

The new IRS installment sales law for real estate repeals the earlier 30% down payment ceiling, and is retroactive to January 1, 1980. The gain percentage continues to be applied to the down payment, even though that payment may be well in excess of 30%. If, for instance, the selling price of $100,000 represents recovery of a cost of 25% plus a gain of 75%, a down payment of $50,000 will be taxed as $37,500 gain, with the balance of $12,500 considered a non-taxable return of capital.

Disadvantages

The biggest problems with real estate are its illiquidity and immobility. If the need to sell is urgent, the timing may be bad, i.e., interest rates may be prohibitively high or mortgage money may be lacking. It may even be in those months of the year when property moves slowly. Money that is tied up in the equity of property cannot be used for any other purpose (although if enough equity has been built up the property can be financed, but this does involve additional expense in closing costs.)

Another disadvantage is related to maintenance and management, which can be a problem with a single family residence but will become a crucial trouble factor in income producing residential property unless some provision is made to solve it. It is feasible for the owner to maintain a modest apartment house but increasing the number of units will, at some point, necessitate the hiring of maintenance and managerial help. Even with owner management there must be some emotional containment of inconvenience of arranging for service and repairs. It is difficult for a potential investor to decide how big is too big for comfortable ownership of property.

The emotional aspect of real estate can be a major disadvantage. Property owners often refuse to recognize the social and/or economic factors that may contribute to the downpricing of their property, and continue to retain the property because it is home, or because it is an inherited apartment and "if this apartment house was good enough for Dad it is good enough for me."

Social changes mean changes in various kinds of desirability. For example, thirty years ago a corner lot was highly attractive. Today a corner lot is not as desirable because it lacks privacy and usually has a small back yard. The present day buyer is not interested in a one-bath home, and is dismayed if the house lacks a first floor family room. Changing traffic patterns or encroaching industry may have made an area very noisy. An apartment building may not have safety provisions that are adequate for today's conditions. An area that has traditionally been the residence of single families may gradually become a two-family residential area. Prices may deteriorate with the overbuilding of certain types of residential property such as condominums, a familiar sight of the 70s in many vacation areas. Deterioration of schools or the rise of crime in an area will diminish the value of residential property, even in the eyes of a long-time owner.

Disarming the Disadvantages

Some of the detrimental factors can be changed. Before remodeling is actually contracted, however, the owner should seek advice from a number of sources, including the advice of a Realtor. (A Realtor® is a person who is a member of the National Association of Realtors® and subscribes to this national association's Code of Ethics.) Too often an addition, such as a first floor family room, adds nothing to the sale value of a house because of its placement. In fact, it can often diminish the value of a home if it is placed too far from the kitchen, or if access to it requires passage through the living room. The addition of a second bathroom in each apartment of a multi-family dwelling is a negative investment in a neighborhood where the rents cannot be raised to accomodate this luxury. The poorly placed family room, and gratuitous extra bathrooms, or any similar addition constitute *value in use*, but mean absolutely nothing in real value and will put no money in the owner's pocket.

Doomsayers predict a break in the real estate bubble but history shows that real estate has generally risen in price over the years, and in recent years it has risen substantially. The danger of price erosion is greater for speculators because speculators, by definition, are greater risk takers. A prudent investor with consistent study of the market does not assume the same posture.

Before turning away from the scary thought of the bursting bubble it may be useful to compare the psychology of people who dream of making enormous wealth in real estate, and those who are content with a good return on their investment. There are many real estate seminars, and many more books that only appeal to greed; there are also many seminars and books on bona fide real estate transactions. It may further temper the craving for instant bounty if the buyer considers the proportionate share of investment held by the lending institution, probably a savings and loan association. Normally the title holder has contributed only 20-25% of the total purchase price. It is illogical to expect a sumptuous personal return on the investment of a second party.

While thinking of savings and loans institutions, a prospective investor might reflect on the inconsistency of parking extra money in money-market instruments, and then decrying the lack of mortgage money when the perfect property at an acceptable price does come into view. Money-market deposits do not usually supply mortgage money to the community. Savings and loan institutions do provide mortgage funds.

It is illogical to expect a sumptuous personal return on the investment of a second party to a transaction.

Mortgage money help has arrived recently from the Federal National Mortgage Association which has decided to help seller-financiers. When a seller elects to assume the mortgage at a bargain interest rate, to encourage the sale, it is hard to turn the investment into cash should the need arise, unless the seller is willing to take a large discount. Now Fannie Mae will buy the mortgage — but only if it complies with strict lending principles and is negotiated with a qualified savings institution who, presumably, made the early arrangements, and if the mortgage carries a normal 20-30 year payment plan with no balloon provisions. A mortgage broker or savings and loan association can best advise a prospective seller as to the complexities of the new program.

Risk Taking

Real estate ties up a substantial amount of money and, like any investment, carries some risk. It is one thing, psychologically, to risk $2,000 in the equity market or in bonds and quite another to deposit ten times that amount on a piece of property, plus agreeing to pay for the balance on a mortgage plan. Women in particular have not been conditioned to accept risk as part of fortune-finding.

There are ways to make all things possible, and even to dilute the risk. "Creative financing" is a current buzzword, explored in its many angles in both popular and technical periodicals. "Co-purchasing" is a recent addition to real estate vernacular and means just that. Two couples or several individuals team up to jointly buy a condominium or urban townhouse or even a country manor that they could not otherwise afford. Any sensible person will engage legal service in drawing up an agreement as to duties, obligations and privileges, as well as disposition possibilities before investing with a

What kind of housing is going to appeal to an older population?

group. A word to the wise: houses last longer than some marriages so a married co-purchaser should include a single exit provision, just in case.

One interesting risk maneuver originated by the savings institutions is known as the shared appreciation mortgage (SAM), and is designed to ease the high interest drain on home buyers, and at the same time give the lender a chance to share in the inflationary rewards on resale. It is outlined below for the affluent investor who may wish to utilize some of the monies presently on deposit and eroding in value:

1) Find a prospective buyer(s), impecunious but upwardly mobile and with an A-1 credit rating.
2) Extend a loan for the entire purchase price of a modest house in a good location, contingent upon the buyer's agreement to:
   a. resell in three years or less, and
   b. repay the loan in a pattern based on normal mortgage time horizons, at an agreed rate of interest that is *lower than the prevailing rate*, and
   c. Split the profits (losses) with the lender in a mutually agreed ratio, usually 50/50.

The reader will recognize this strategy as a real estate version of the convertible bond hedge against inflation: some interest is forfeited in expectation of a rising market and consequent conversion with a capital gain.

The Rest of the Decade

The problems of high inflation, high unemployment and dwindling energy supplies must be solved in the political arena. Other problem areas, more correctly identified as social phenomena, can present great opportunities for the real estate investor.

A Nation of Oldsters

It is evident that the population of the United States is becoming older, and not only older but far more healthy and vigorous than its ancestors. Many advertised products are promoted today not by some lissom miss, but by an older, fatter temptress. The message is to the older buyer, more often than not. Aspirin, for instance, was traditionally the remedy for headaches only; now T-V commercials regularly stress its arthritis relieving properties. Media marketeers know on which side their bread is buttered, and their recognition of major customer segments can be a productive hint for real estate investment.

What kind of housing is going to appeal to an older population? Will the elderly stay in the family home longer; will they be troubled with the continued maintenance on that home? If they are dissatisfied, what changes will they make? Can they be satisfied with a home smaller than the one to which they are accustomed? What compromises will they accept?

Will two spacious bedrooms compensate for four bedrooms of average size? Is the first floor family room expendable? During the 50s one-floor-plan houses were immensely popular although their popularity is waning today. Will they continue to appeal to older people who can no longer cope with a large two-floor home and must concede the inroads of time on knee joints and hearts? Will the elderly change their entire style of housing? Will carefree renting be a more satisfactory mode of life?

Can oldsters take to heart the message of recent books that advise spending one's own inheritance? For many, the thesis goes, their equity in their home is their savings and they should not feel guilty about spending the storehouse of a lifetime.

Proceeds from selling the homestead may be reinvested at interest then withdrawn in an annuity pattern of periodic payments, to supplement monthly social security benefits and any other assured income, such as a company pension. A quick actuarial application of life expectancy, in months, as a divider into lump sum proceeds will indicate the amount that may be safely withdrawn for one person, per month. If both members of a couple survive the divider must include both life expectancies, in months. Interest accrual on the declining balance over the years will delay exhaustion of the money reservoir, of course. Such a liquidation and withdrawal plan may not be highly popular with potential heirs to the estate but the process can change retirement from meager existence to gracious living.

So the older couple agree that home ownership is no longer for them. Where are they going to live? Will they want an apartment? Would a mobile home, with possibility of permanent installation in a tourist park, be more to their liking? Would they prefer some small communal dwelling where they, and a few congenial tenants, would each have a personal, private area but share meals and companionship in a common area? Or when only one member of a couple survives, or when age and infirmity have limited the capacities of both, will the housing solution be a senior citizen home that provides total care for the rest of life? What possibilities for real estate investment accompany this phenomenon of an aging nation!

The Young Point of View

The much discussed housing shortage stems, in part, from the post World War II baby boom. Cyclical birth rate patterns must be considered by any astute real estate investor, and in that connection one should bear in mind that 1990 is predicted as the beginning of a decidedly lower birth rate era.

Today's young adults are better educated, more highly motivated and more upwardly mobile than their parents. Most of them were reared in the tradition of home ownership. Young women today insist that they are whole persons and entitled to a full life, whether in family building or in a career, or both. Young people eat more meals out than their parents did. They segment their lives, expect to have more than one career and more than one type of housing over their life-span, and they are accustomed to instant gratification.

Given those well-known facts, the investor must estimate the probable housing pattern for young adults. Will they become house-poor, as their parents were at the same age, or will they refuse to yield on non-essentials such as extra meals out that might help pay the monthly mortgage installments? If they do acquire property will they fix it up so that it will bring a greater return on investment when it is resold? And what about young wives? Will their newly raised consciousness accommodate to the restrictions, and occasional nuisance, of home ownership maintenance?

According to statistics compiled by the National Association of Realtors®, in 1979 more than 200,000 homes nationally were bought by single women — women who were divorced, widowed or unmarried. The present trend toward home ownership by single men and women is a fast-growing phenomenon. Does that mean that they will drift away from rental property? Probably not, but if they do prefer to rent they also will expect luxurious extras such as swimming pools, tennis courts, nearness to transportation, and special provisions for safety and privacy.

Mature owners of personal homes will eventually be selling to the younger market, and will have to sell to them on their terms. If the home is outdated with out-of-fashion painting and papering, money must be spent to bring it into harmony with young decorating ideas. If the kitchen is the original one, owners who are a few years away from retirement can remodel and enjoy the results in the interim, knowing that the investment will be recouped at time of sale. Young buyers want air conditioning, so if a weary furnace must be replaced it is prudent to install air conditioning at the same time. For the next ten years there probably will not be enough good single family homes to meet the demand, unless building starts to increase.

What is the composition of the family of the 80s? Fifty years ago the home usually contained at least one grandparent, the mother and father, and all unmarried children. That is no longer the case. Grandparents still enjoy seeing their grandchildren and like to have enough room for them to stay overnight, but they neither want to live with their children nor babysit with their grandchildren on a regular basis. Parents, in too many cases, are divorced and maintaining two households. Smaller children are with one parent or the other, college age children are in their own apartments on the campus and even if they return home after graduation it will be for a limited time and only until financial independence is a reality. Even non-students in late teens are apt to share an apartment with a friend; meanwhile the youngsters of the household observe the exodus and yearn for their own freedom. From grandparents to toddler, there may well be five households where one used to suffice.

Bringing It All Together

Clearly, housing for the 80s offers a great array of investment opportunity. Appreciation of property is almost a foregone conclusion, yet immediate returns will vary according to the knowledgeability of the buyer. One can opt for rental service to the elderly and buy a trailer court close to transportation, or an almost-like-home boarding house, some units in a good senior service village complex, or a traditional apartment house. If catering to young adults seems more promising the choice must be made for a single family home, a condominium, an apartment near college, or an apartment house in a fashionable neighborhood, luxuriously equipped with extras. Risks and financing may be assumed alone, or shared with others.

The trend toward home ownership by single men and women is a fast-growing phenomenon.

Risk, as was pointed out in early paragraphs, is minimized by knowledge. A brief list of suggested reading supplements this article. When the lack of knowledge of a potential real estate investor yields to a reasonable gathering of information it is time to consult a Realtor®, and perhaps an attorney if buying and holding arrangements tend to complicate an investment program. A qualified Realtor® is recognizable by the designation GRI (Graduate, Realtor Institute), or CRS (Certified Real Estate Specialist). These people study real estate on a continuing basis and upgrade their talents regularly to match the sophistication of the 80s buyers and sellers. Ω

Patricia Shannon, B.B.A., *is a Realtor with Sibcy Cline, Inc. of Cincinnati. She is a graduate of the Realtor Institute, has done graduate study at the University of Cincinnati in realty appraisal, and has had marketing and sales promotion positions with Procter & Gamble, and Monsanto Co.*

Suggested additional reading

Weekend Real Estate Investor by Weston Hatfield, McGraw-Hill Book Co., 1978.

Crisis Investing: Opportunities and Profits in the Coming Great Depression by Douglas R. Casey, Stratford Press, 1980.

Inherit Your Own Money by Elmer Otte, David McKay Company, Inc. 1978.

How To Prosper During The Coming Bad Years by Howard J. Ruff, The New York Times Book Co., Inc., 1979.

Nothing Down: How To Buy Real Estate With Little Or No Money Down by Robert G. Allen, Simon & Schuster, 1980.

Houses: The Illustrated Guide to Construction, Design and Systems by Henry S. Harrison, Realtors (R) National Marketing Institute, 1973.

Statement of Financial Accounting Standards No. 33:

An Experiment in Reporting Price Level Adjustments

By Mary R. Golden

Most accountants are aware of the expressed problems with traditional historical cost accounting and the leading proposed solutions, i.e. general price-level accounting and current value accounting. It is difficult, however, to keep current in all phases of our profession and those who do not teach financial accounting or work with large firms may not be aware of the current reporting requirements concerning price-level changes and their impact on a company's financial position. With this in mind, the following is a review of *Statement of Financial Accounting Standard No. 33,* "Financial Reporting and Changing Prices," published by the Financial Accounting Standards Board (FASB) in September 1979.[1]

Introduction

Since, in the Board's own words, this *Standard* is experimental, the required disclosure is on a supplemental basis only. The primary financial statements will continue to be based on the traditional historical cost concept. The reasons for retaining historical cost, according to the FASB, are:

1) It is fitting that the financial statements depend on actual transactions of the enterprises because those transactions determine the change in owners' equity in the long run.
2) Historical prices generally are the result of arms-length bargaining; they provide a basis for reliable measures of the results of transactions. Accordingly, these figures can be verified.
3) Users' understanding of the effect of changing prices may be enhanced if they are able to compare the measurements in the primary financial statements with measurements that reflect changing prices.
4) Users are accustomed to the present financial statements.

Also, due to the experimental nature and the cost that would be incurred in the production of the information required, the board decided to require only large, public firms to disclose the supplemental data. Large is defined as those firms with either (1) inventories and property, plant and equipment (gross) amounting to more than $125 million, or (2) total assets amounting to more than $1 billion at the beginning of the year. The reasoning was that many large firms were already preparing certain data for the Securities and Exchange Commission and they had the accounting systems and personnel to provide the information.

The Board believes that information on changing prices is necessary in order to (1) allocate resources efficiently, (2) increase investor and creditor's understanding of the past performance of an enterprise, (3) provide important information to people in government who participate in decisions on economic policy, and (4) promote a better understanding by the general public of the problems caused by inflation. Further, numerical information, such as required in this *Standard,* will have more impact than various written explanations by management concerning the effect of inflation on the company.

The Board members deliberated over whether the effect of general inflation or specific inflation was more important and, therefore, should be disclosed to the readers of the financial statements. In typical committee fashion, they concluded that both types of information are *likely* (their words) to be useful. This conclusion was based on comments solicited during the exposure draft period. In general, preparers of financial statements, e.g. accountants and company management, felt that general price-level changes only should be disclosed in the financial statements; while users of financial statements expressed a preference for information concerning specific price-level changes.

The terminology used in *Standard No. 33* differs somewhat from previous reports and general literature on the subject of price-level changes. Traditional reporting is referred to as a "historical cost/nominal dollar" system. Information adjusted for changes in the purchasing power of the dollar is termed "constant dollar" accounting. Constant dollar accounting is synonomous with general price-level or general purchasing power accounting. The Consumer Price Index (CPI) was chosen as an indicator of the change in purchasing power.

The third "new" term used is "current cost" accounting. Current cost differs from current value accounting, according to the Board, in that current cost is concerned only with the measurement of assets owned by an enterprise. Current value accounting, on the other hand, implies not only measurement of assets, but also recognition of gain or loss due to the change in measurement of the asset. Under *SFAS No. 33* the increase or decrease in the current cost of assets is not to be included in income from continuing operations. By adopting the new phrase, current cost, the Board has retained the traditional realizaion concept and hopes to sidestep one traditional criticism of current value accounting, i.e. recognition of pre-realization revenue.

Table 1
Reporting Requirements Under SFAS #33

I. Current Fiscal Year
   A. Income from continuing operations on a historical cost/constant dollar basis, using the average dollar for the year. Must disclose changes in cost of goods sold, depreciation, depletion, and amortization.
   B. Purchasing power gain or loss on net monetary items.
   C. Income from continuing operations on a current cost basis.
   D. Current cost amounts of inventory and property, plant and equipment at the end of the year.
   E. Increases or decreases for the current fiscal year in the current cost amounts of inventory and property, plant and equipment, net of general inflation.

II. Five Most Recent Fiscal Years (stated either in average year dollars for the current fiscal year or 1967 dollars)
   A. Net sales and other operating revenues.
   B. Historical cost/constant dollar information:
      1. Income from continuing operations.
      2. Income per common share from continuing operation.
      3. Net assets at fiscal year-end.
   C. Current cost information:
      1. Income from continuing operations.
      2. Income per common share from continuing operations.
      3. Net assets at fiscal year-end.
      4. Increase or decrease in current cost amounts of inventory and property, plant and equipment, net of general inflation.
   D. Purchasing power gain or loss on net monetary items.
   E. Cash dividends declared per common share.
   F. Market price per share at fiscal year-end.
   G. Consumer price index (CPI) used for measurement of income from continuing operations.

III. Narrative explanations of the inflation adjusted information.

Reporting Requirements

Table 1 is a summary of the disclosure requirements mandated by *Standard No. 33*. The following is an explanation of the methodology that must be used in arriving at the requested information.

Current fiscal year reporting

The first requirement is to disclose the current fiscal year's income from continuing operations on a historical cost/constant dollar basis, using the average dollar for the year. The only components of income from continuing operations that must be adjusted for general inflation are cost of goods sold, depreciation, depletion, and amortization. All other items, including income tax expense, are not adjusted. The Board stressed throughout the *Standard* that this reporting was on an experimental basis and, as such, estimates and approximations would be allowed. Since cost of goods sold and depreciation, depletion, and amortization would be affected by inflation more than other revenue or expense items, these are the only items requiring adjustment. The average dollar is used as a basis rather than the end of the year dollar. This is because a majority of revenue and operating expense items are already expressed in average year dollars. The adjusted cost of goods sold, depreciation, depletion and amortization then would be on a consistent basis with other income items. This internal consistency would provide a better approximation of income from continuing operations on a constant dollar basis with a minimal adjustment of accounts. An exception to the use of the average dollar is allowed when companies prepare complete financial statements on a constant dollar basis. These companies can report on an end-of-the-year dollar basis.

Purchasing power gains or losses on net monetary items must also be disclosed. Again, in order to expedite the gathering of this new information, the Board has provided a short cut approach to the calculation of the purchasing power gain or loss, as shown in Table 2. This method arrives at an approximation of the purchasing power gain or loss by assuming that all changes in monetary items occurred on an even basis throughout the year. This assumption has some validity for the majority of companies. Because of the disagreement among accountants over the classification of purchasing power gain or loss, this gain or loss is not included as a component of income from continuing operations for purposes of this *Standard*.

The third item to be disclosed for the current year is income from continuing operations on a current cost basis. Again, cost of goods sold, depreciation, depletion and amortization are the only components of income to be adjusted for specific price-level changes. These adjusted items are based on the current cost of the restated assets which is described in the following paragraph. Depreciation is still an allocation figure and, in general, is based on the same assumptions about useful life and residual value used in preparing historical cost financial data. The average current cost for the year is used as the basis of depreciation.

The current cost of inventory and property, plant and equipment used in calculating the adjusted expenses above is the fourth item of disclosure required in *SFAS #33*. While not

Table 2
Shortcut Approach to Calculation of Purchasing Power Gain or Loss

Assumption: Company has net monetary liability position at both beginning anc end of year.

Net monetary liabilities ities at beginning of period in nominal dollars	X	$\frac{\text{Average Current Year CPI}}{\text{Beginning of Year CPI}}$	=	Net monetary liabilities at beginning of period in average year dollars
ADD:				Increase in net monetary liabilities (assumed to be in average year dollars)
				Ideal net monetary liability position at end of year if company has kept pace with inflation
DEDUCT:				
Net monetary liabil-ities at end of period in nominal dollars	X	$\frac{\text{Average Current Year CPI}}{\text{End of Period CIP}}$	=	Net monetary liabilities at end of period in average year dollars
				Purchasing power gain or (loss) in average year dollars

specifying the manner in which current costs are to be derived, the *Standard* does include suggested methods that could be utilized. These are: 1) indexation, either externally or internally generated, and 2) direct pricing from current invoices, vendor price lists or current standard costs. The technique used must be disclosed.

The fifth and final item that must be disclosed for the current fiscal year is the increase or decrease in the current cost of inventory and property, plant and equipment. This change must be shown net of general inflation.

Five Year Information

All of the information required to be disclosed relevant to the current fiscal year is also required for the five most recent fiscal years including the current year. It appears that this is a duplication of effort until the requirement is examined closely. The required information for the current fiscal year is based on the current year average dollar. The five year data is based on the purchasing power of either the current year average dollar or the base year used for the Consumer Price Index, currently 1967. The *Standard* included this flexibility for experimental purposes.

Both bases have potential credibility problems. In the five year data based on the current year average dollar, prior year data would have to be restated every year. Readers may not understand the changed figures when comparing the same year figures in two different annual reports. If the five year data is based on 1967 dollars, no restatement would be necessary in subsequent years; but, the data relating to the current fiscal year would not agree with the data in the current year's financial statements. This, of course, could also place doubts in the minds of readers concerning the data's reliability. The purpose of requiring constant dollar data for the five year period was to provide comparable data in real terms. Using either the current year average dollar or the 1967 dollar achieves this purpose.

Other than the adjustment to a constant dollar basis, all information required for the five year comparison is calculated in a manner similar to the current year disclosures. Four additional items are required for the five year summary: (1) income per common share from continuing operations on both a historical cost/constant dollar basis and a current cost/constant dollar basis; (2) dividends per common share; (3) market price per share; and (4) the Consumer Price Index used for measurement of income from continuing operations.

Conclusion

Since the required disclosures under *SFAS No. 33* are experimental in nature, a phase-in period for reporting certain data was established. In addition, a time period was established during which the Board will review the experience of firms with the *Standard* and decide whether to continue, expand, or delete the reporting requirements relevant to price-level changes. Ω

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Readership Survey

In order to better serve the needs of our readers, THE WOMAN CPA is doing a survey to compile statistics. Please complete and return to:

READERSHIP SURVEY
THE WOMAN CPA
Box 944
Cincinnati, OH 45201

1) State you live in: ____________________

2) Are you a CPA? ____________________

3) Years of full-time work experience: ____________________

4) Sex ____________________

5) Is your job related to accounting? ____________________

6) Are you a full-time student? ____________________

7) Are you a part-time student? ____________________

8) Work status (check one)

Self-employed ____________________

Employed full-time ____________________

Employed part-time ____________________

Unemployed ____________________

Retired ____________________

10) Annual Income: ____________________

$10,000 to $20,000 ____________________
$20,000 to $30,000 ____________________
$30,000 to $50,000 ____________________
$50,000 to $75,000 ____________________
$75,000 and over ____________________

11) Do you support dependents?
Wholly ____________________
Partially ____________________

Readership Survey (Continued)

12) Present employment is in:
- Public accounting ______
- Education ______
- Industry ______
- Non-profit organization ______
- Services ______
- Others (indicate) ______

13) How many do you supervise? ______

14) Level of responsibility:
- Top management ______
- Supervisory ______
- Other ______

15) Age: ______
- Under 25 ______
- 26-35 ______
- 36-45 ______
- 46-55 ______
- 56-65 ______
- 66 and over ______

16) Indicate highest level of education: ______

17) Do you own your own home? ______

18) Value of home: ______
- Under $50,000 ______
- $50,000 to $100,000 ______
- $100,000 to $150,000 ______
- Over $150,000 ______

19) Do you own investment property? ______

20) Do you own stocks, bonds, etc.? ______

21) Have you traveled outside U.S. in past two years? ______
- Business ______
- Pleasure ______

22) How many times have you flown in past year? ______

23) How many nights have you spent in hotel/motel on business in the past year? ______

24) Articles you liked in THE WOMAN CPA

25) Topics you would like to see published in THE WOMAN CPA:

Financial Executive Reaction To The CMA

A Four-tiered Survey

by Larry Kreiser and John C. Talbott

The Certificate in Management Accounting (CMA) was instituted in 1972 by the National Association of Accountants. The objectives of the CMA program are "to establish management accounting as a recognized profession, to foster high educational standards in the field of management accounting, and to assist employers, educators, and students by establishing an objective measure of an individual's knowledge and competence in the field of management accounting." (CMA Brochure)

In order to be awarded a CMA, a person must pass a five-part, seventeen and one-half hour examination and have at least two years of professional experience in management accounting. Financial analysis; budget preparation; management accounting and auditing in government, finance, or industry; management consulting; in-charge audit work in public accounting; and full-time teaching in management accounting are among the employment activities which will satisfy the professional experience requirement. As of October 1980, 2,130 persons have been awarded the CMA since the inception of the program.

The CMA program has been gathering momentum over the past few years. Each year, a growing number of professionals in government, education, and industry are taking the CMA examination and are being awarded the CMA. Positions available ads are also starting to list the CMA as a desirable designation.

Based on the increasing recognition of the CMA, this study was designed to determine the importance of the CMA as perceived by financial executives. In addition, the study was designed to determine if there has been any change in financial executive reaction to the CMA over the period 1976-1980.

Research Methodology

Empirical evidence needed for this study was collected by means of three mailed questionnaires. Identical questionnaire surveys were conducted in 1976, 1978, and 1980. Copies of the three questionnaires were sent to the chief financial officer in each of the top 500 industrial corporations in America as listed in *Fortune Magazine*. The 1976 survey had a 47 percent response rate while the 1978 and 1980 surveys each had a 40 percent response rate.

All responses were examined for statistically significant differences in the distribution of responses within each survey and between the three surveys. Two statistical tests were applied. A chi-square test for the fit of a uniform distribution at the 0.05 percent level of significance was used to determine if responses to each question on each survey were uniformly distributed over the possible answers to each question; or, whether the distribution of answers was skewed in one direction thereby indicating significant agreement among the respondents. For purposes of this study, the term significant agreement as used here is defined as a distribution of responses differing significantly from a uniform distribution of responses. In applying this test, undecided responses were not considered. The test indicated that for the nine 1976 survey questions, there was significant agreement among the respondents on seven questions and a lack of consensus on two questions. For the 1978 survey, there was significant agreement on eight questions and a lack of consensus on one question. On the 1980 survey, there was significant agreement on seven questions and a lack of consensus on two questions. The lack of consensus on some questions is discussed in later sections of the study.

A chi-square test of homogeneity at the 0.05 percent level of significance in the frequency of expressed opinions between the respondents to the three surveys. In applying this test, undecided responses were not considered. The test indicated that for the nine survey questions, there were homogeneous responses between surveys on eight questions and a significant difference in expressed opinion between surveys on one question. The significant difference is discussed in a later section of the study.

Results of Survey

Responses to the nine questions on the survey questionnaire are analyzed in the following four groupings: present importance of CMA certificate, future importance of CMA certificate, importance of CMA certificate for college curriculum development, and the value of a grandfather clause in improving the recognition of the CMA certificate.

TABLE 1. — Financial executive responses to two questions on the present importance of CMA certificate

1. In regard to internal advancement, the CMA is currently of substantial importance.

	Answer	1976 Survey	1978 Survey	1980 Survey
a.	Agree	15%	20%	22%
b.	Disagree	70	57	67
c.	Undecided	15	23	11
	Total	100%	100%	100%

2. In regard to external mobility, the CMA is currently of substantial importance.

	Answer	1976 Survey	1978 Survey	1980 Survey
a.	Agree	20%	29%	25%
b.	Disagree	60	49	59
c.	Undecided	20	22	16
	Total	100%	100%	100%

TABLE 2. — Financial executive responses to three questions on the future importance of CMA certificate

1. In regard to internal advancement and external mobility, the CMA will be of substantial importance in the future.

	Answer	1976 Survey	1978 Survey	1980 Survey
a.	Agree	42%	47%	38%
b.	Disagree	31	26	35
c.	Undecided	27	27	27
	Total	100%	100%	100%

2. The CMA will eventually become as important for management accountants as the CPA is currently for public accountants.

	Answer	1976 Survey	1978 Survey	1980 Survey
a.	Agree	23%	24%	26%
b.	Disagree	63	62	64
c.	Undecided	14	14	10
	Total	100%	100%	100%

3. The CMA will eventually become a requirement for higher ranking financial positions within industry.

	Answer	1976 Survey	1978 Survey	1980 Survey
a.	Agree	11%	16%	15%
b.	Disagree	71	68	69
c.	Undecided	18	16	16
	Total	100%	100%	100%

Present importance of CMA certificate. Table 1 presents financial executive responses to two questions on the present importance of the CMA certificate. For both questions, the responses to all three surveys were homogeneous. The majority of financial executive respondents did not consider the CMA to be of substantial current importance in regard to internal advancement or external mobility.

Future importance of CMA certificate. Table 2 presents financial executive responses to three questions on the future importance of the CMA certificate. For all three questions, the 1976, 1978, and 1980 survey responses were not significantly different. The majority of financial executives disagreed with two of the three questions regarding the future importance of the CMA certificate. Financial executive responses to the 1980 survey lacked a consensus as to whether the CMA will be of substantial importance in the future in regard to internal advancement and external mobility.

TABLE 3. — Financial executive responses to two questions on the importance of the CMA certificate for curriculum development

1. College accounting departments should consider the CMA in designing curricula and advising students on career goals.

Answer	1976 Survey	1978 Survey	1980 Survey
a. Agree	54%	66%	57%
b. Disagree	22	17	19
c. Undecided	24	17	24
Total	100%	100%	100%

2. In regard to recruiting, industrial companies would prefer to hire students who have completed a CMA oriented accounting curriculum.

Answer	1976 Survey	1978 Survey	1980 Survey
a. Agree	40%	52%	41%
b. Disagree	36	24	31
c. Undecided	24	24	28
Total	100%	100%	100%

Importance of CMA certificate for college curriculum development. Table 3 lists financial executive responses to two questions on the CMA certificate and college curriculum development. A majority of financial executives thought that college accounting departments should consider the CMA in designing curricula and advising students on career goals. Responses to all three surveys were homogeneous in this respect. Financial executive responses to the 1976 survey and 1980 survey lacked a consensus in regard to whether companies would prefer to hire students who have completed a CMA oriented accounting curriculum. There was also a significant difference in expressed opinions between the three surveys on this question.

TABLE 4. — Financial executive responses to two questions on a CMA grandfather clause

1. Current corporate controllers and chief financial officers for New York and American Stock Exchange companies should be awarded CMAs based on position and experience as opposed to being required to pass an examination.

Answer	1976 Survey	1978 Survey	1980 Survey
a. Agree	18%	26%	18%
b. Disagree	55	50	59
c. Undecided	27	24	23
Total	100%	100%	100%

2. A "Grandfather Clause" similar to the one mentioned in the preceding question would increase the recognition of the CMA.

Answer	1976 Survey	1978 Survey	1980 Survey
a. Agree	39%	44%	33%
b. Disagree	40	41	49
c. Undecided	21	15	18
Total	100%	100%	100%

Value of a grandfather clause in improving the recognition of CMA certificate. Table 4 presents financial executive responses to two questions on a CMA grandfather clause. A majority of financial executives did not support a CMA grandfather clause. All three surveys were homogeneous in this regard. Financial executive responses to both the 1976 survey and the 1978 survey lacked a consensus as to whether a grandfather clause would increase the recognition of the CMA certificate.

Summary and Conclusions

Based on the empirical evidence gathered in this study, the following general observations can be noted.

1. *Current importance of CMA.* A majority of financial executives did not consider the CMA to be of substantial current importance in regard to internal advancement or external mobility. All three surveys were homogeneous in this respect. The relative newness of the CMA program and the fact that, at present, there are less than 2,500 CMA holders may all contribute to this lack of current importance.

2. *Future importance of CMA.* The financial executives disagreed with two of the three questions regarding the future importance of the CMA certificate. A large majority of financial executives did not believe that the CMA will eventually become a requirement for higher ranking financial positions within industry. One can surmise that there is no compelling reason (i.e. CPA—Public Interest) why it should be mandatory for a person to have a CMA in order to be promoted to a higher ranking financial position in industry.

3. *The CMA and college curriculum development.* A large majority of financial executives thought that college accounting departments should consider the CMA in designing curricula and advising students on career goals. In 1977, a nationally distributed newspaper article discussed the preferences of some financial executives for CMA oriented career training. (Fowler) Accounting departments might want to consider the CMA program as a guide to the types of training expected of a management accountant and, where possible, modify their curriculum accordingly.

4. *CMA grandfather clause.* CMA program directors decided against using a grandfather clause when the

program was initiated in 1972. A majority of financial executives did not favor the awarding of CMAs based on position and experience as opposed to being required to pass an examination. Financial executive responses to both the 1976 and 1978 surveys also lacked a consensus as to whether a grandfather clause would increase the recognition of the CMA certificate. This would tend to indicate that there is no widespread support among financial executives for a grandfather clause.

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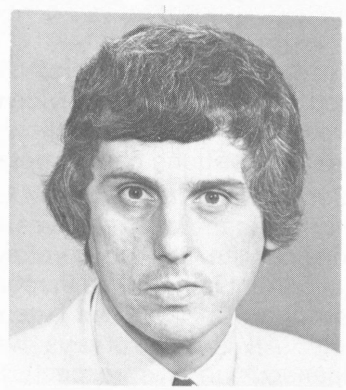

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International Accounting

The Proposed Statement on Foreign Currency Translation

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The FASB recently issued an Exposure Draft of a Proposed Statement of Financial Accounting Standards on "Foreign Currency Translation."[1] The Proposed Statement, if approved and issued, would replace Statement No. 8,[2] which has been the subject of persistent and almost unanimous criticism by both accountants and financial managers virtually since its issuance.[3] It is the purpose of this column to explain and illustrate the provisions of the Proposed Statement and to highlight the major differences between it and Statement No. 8.

Provisions Of The Proposed Statement

The Exposure Draft proposes the use of the current rate of exhange for translating the financial statements of a foreign entity which are incorporated in the financial statements of the reporting entity by consolidation, combination, or the equity method of accounting. According to the FASB the current rate method preserves the financial results and relationships as measured in the functional currency[4] and produces results that are consistent with the economic effects of exhange rate changes. Consequently the foreign entity's assets and liabilities will be translated at the rate in effect at the balance sheet date. Revenues, expenses, gains and losses ideally should be translated at the rate in effect on the day the items were recognized; cost of goods sold and depreciation should be translated at the rate in effect during the period. Since the determination of all these rates might be impractical, the Proposed Statement accepts the use of a weighted average exchange rate for the period for the translation of all income statement items.

The Proposed Statement distinguishes between "adjustments"[5] resulting from the translation of the foreign entity's financial statements and "gains or losses" from foreign currency transactions. The adjustments resulting from the translation of the foreign entity's financial statements are not to be included in the determination of net income; they are, instead, to be reported in the equity section of the reporting entity's balance sheet. Also excluded from the income statement are the results of foreign currency transactions designed to serve as economic hedges against the net investment in a foreign entity and those between an investor and its investee. All other gains or losses from foreign currency transactions should be included in the determination of net income.

The adjustment account resulting from the translation of the foreign entity's financial statements may be reduced when all or part of the investment in the foreign entity is sold. The portion considered realized should be removed from the equity section and included in the income statement. The same accounting treatment should be followed when the investment in a foreign entity is impaired.

The Proposed Standard requires the following disclosure in the financial statements or in notes thereto:

1. The aggregate gain or loss included in net income (gains or losses from foreign currency transactions, realized gains or losses from forward exchange contracts, and realized gains or losses from liquidation or impairment of the investment account);

2. The effect of rate changes in income, if practicable;

3. An analysis of changes in the accumulated adjustment account (beginning balance, changes during the period, and the ending balance);

4. Changes in exchange rates after the balance sheet date and their effect on the foreign currency transactions.

Differences Between The Proposed Standard And Statement No. 8

In order to highlight the changes from Statement No. 8 to the Proposed Statement Exhibit 1 has been prepared. It illustrates the translation of the financial statements of a foreign subsidiary into US dollars under both Standards. For the purpose of this illustration the following exchange rates are assumed:

	Foreign Currency	:	Dollar
January 1, 1980	1.00	:	1.00
December 31, 1980	1.00	:	.80
Average for 1980	1.00	:	.90
December 31, 1981	1.00	:	.90
December 31, 1981	1.00	:	.90
Average for 1981	1.00	:	.85

It is also assumed that property, plant, and equipment was acquired when the exchange rate was FC 1 : $1; that the ending inventory in 1979 was also acquired when the exchange rate was FC 1 : $1; that the 1980 ending inventory was purchased when the exchange rate was FC 1 : $.95; and that the ending inventory in 1981 was acquired when the exchange rate was FC 1 : $.85. It is further assumed that on December

EXHIBIT 1
Translation of the Financial Statements of a Foreign Subsidiary

	FC (000)		Statement No.8 12/31/80		12/31/81		Proposed Statement 12/31/80		12/31/81	
	12/31/80	12/31/81	Rates	Dollars (000)	Rates	Dollars (000)	Rates	Dollars (000)	Rates	Dollars (000)
Balance Sheet										
Cash	200	400	.80	160	.90	360	.80	160	.90	360
Receivables (net)	400	500	.80	320	.90	450	.80	320	.90	440
Inventory	600	600	.95	570	.85	510	.80	480	.90	540
Property, Plant & Equip. (net)	1,200	1,140	1.00	1,200	1.00	1,140	.80	960	.90	1,026
	2,400	2,640		2,250		2,460		1,920		2,376
Current Liabilities	600	486	.80	480	.90	437	.80	480	.90	437
LT Liabilities	900	990	.80	720	.90	891	.80	720	.90	891
Capital Stock	300	300	1.00	300	1.00	300	1.00	300	1.00	300
Retained Earnings	600	864		750		832		576		801
Translation Adjustment	0	0		0		0		(156)		(53)
	2,400	2,640		2,250		2,460		1,920		2,376
Income Statement										
Sales	4,800	5,280	.90	4,320	.85	4,488	.90	4,320	.85	4,488
Cost of Goods Sold	(2,400)	(2,640)		(2,310)		(2,304)	.90	(2,160)	.85	(2,244)
Depreciation	(60)	(60)	1.00	(60)	1.00	(60)	.90	(54)	.85	(51)
Selling & Adm. Expense	(1,770)	(1,953)	.90	(1,593)	.85	(1,660)	.90	(1,593)	.85	(1,660)
Interest Expense	(90)	(99)	.90	(81)	.85	(84)	.90	(81)	.85	(84)
Translation Gain (Loss)	0	0		330		(74)		0		0
Income Taxes	(240)	(264)	.90	(216)	.85	(224)	.90	(216)	.85	(224)
Net Income	240	264		390		82		216		225
Key Financial Ratios										
Current Ratio	2:1	3.09:1		2.19:1		3.02:1		2:1		3.09:1
Rate of Return on Assets	10%	10%		17-1/3%		3-1/3%		11.25%		9.46%
Rate of Return on Equity	26-2/3%	22.68%		37.14%		7.24%		30.00%		21.46%
LT Debt to Equity	100%	85.05%		68.57%		78.71%		69.76%		85.05%

31, 1979 the net monetary assets were a negative FC 1,200, i.e. that the monetary liabilities exceeded the monetary assets by FC 1,200. The net assets at that time were FC 660.

The translation of the cost of goods sold under the provisions of Statement No. 8 is computed as follows:

	FC	1980 Rate	$	FC	1981 Rate	$
Beginning Inventory	600	1.00	600	600	.95	570
Purchases	2400	.95	2280	2640	.85	2244
	3000		2880	3240		2814
Ending Inventory	600	.95	570	600	.85	510
Cost of Goods Sold	2400		2310	2640		2304

The computation of the translation adjustment under the Proposed Statement is as follows:

	1980			1981		
	FC	Rate Change	$	FC	Rate Change	$
Accumulated Translation Adjustment at beginning of period			0			(156)
Net Assets at beginning of period	660	(.80-1.0)	(132)	900	(.90-1.0)	90
Net Income for the year	240	(.80-.90)	(24)	225	(.90-.85)	13
Net Change for the year	900		(156)	1125		103
Accumulated Translation Adjustment at end of period			(156)			(53)

The translation gains and losses under the provisions of Statement No. 8 are computed as follows:

	1980			1981		
	FC	Rate Change	$	FC	Rate Change	$
Beginning Balance of Net Monetary Liability	1200	(1.00-.80)	240	900	(.80-.90)	(90)
Purchases	2400	(.95-.80)	360	2640	(.85-.90)	(132)
Selling & Adm. Expense	1770	(.90-.80)	177	1953	(.85-.90)	(98)
Interest Expense	90	(.90-.80)	9	99	(.85-.90)	(5)
Income Taxes	240	(.90-.80)	24	264	(.85-.90)	(13)
Sales	4800	(.90-.80)	(480)	(5280)	(.85-.90)	264
Net Change for the Period			90	324		16
Gain (Loss) from Translation			330			(74)

Conclusions

Exhibit 1 shows that the current rate method as advocated by the Exposure Draft has several advantages over the temporal method prescribed by Statement No. 8. It preserves the financial relationships as measured in the foreign currency; it results in a positive translation adjustment when the exchange rate is strengthened; and net income is not distorted by translation. Furthermore, it translates revenues and expenses at the same rate and thus produces a better matching of revenues and expenses; it translates both long-term debt and the property financed with that debt at the same rate; and it eliminates the conflict between accounting and economic exposure to foreign currency rate changes.

For the sake of fairness it should be mentioned that the Proposed Statement has been approved by only four members of the FASB. The three dissenting members argue that the concept of a functional currency contradicts the concept of a single consolidated entity and a single unit of measure. They also question the assumption that financial statement users are interested in cash flow measured in the foreign currency, rather than in US dollars. Some also argue that the current rate will understate the non-monetary assets of companies in countries with hyperinflation because the Exposure Draft does not permit price-level adjustments of the foreign currency statements before they are translated into US dollars.

Given the close division in the FASB the fate of the Proposed Statement is uncertain. But whatever the outcome, the debate over foreign currency translation is not likely to disappear.Ω

NOTES

[1] FASB. *Foreign Currency Translation, Proposed Statement of Financial Accounting Standards.* (Stamford, Conn.: FASB), August 28, 1980.

[2] FASB. *Accounting for Translation of Foreign Currency Transactions and Foreign Currency Financial Statement, Statement of Financial Accounting Standard No. 8.* (Stamford, Conn.: FASB), 1975.

[3] For details and analysis of these attacks on Statement No. 8, see:

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[4] Functional currency is defined in the Exposure Draft as the primary currency of the economic environment in which an entity generates and expends cash.

[5] This term is a new term introduced by the Proposed Statement; it is equal to "gains or losses" from translating the foreign entity financial statement. The Proposed Statement has deliberately avoided the use of the term gains or losses in this context.

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The Woman CPA Notes With Pride

Top scorers nationwide in the November, 1979 and the May, 1980 Uniform CPA Examinations were women. At the 1980 annual meeting of AICPA in Boston, Elijah Watts Sells Award medals were presented as follows:

November 1979, Gold Medal
Donna Fudge Anderson,
Anderson, South Carolina

May 1980, Gold Medal
Sally L. Hoffman
Rye, New York

May 1980, Silver Medal
Rose Marie Russo Wells
Honolulu, Hawaii

Shirley B. Schleimer, partner with Rehman, Robson, Osburn & Co., Certified Public Accountants in Saginaw, Michigan was presented the 1980 Public Service Award by the American Woman's Society of Certified Public Accountants at their recent meeting at Cambridge, Massachusetts.

The Public Service Award is presented annually by AWSCPA to a member who has made outstanding contribution of time and talent to her community.

A widely acknowledged challenge for accounting educators is student difficulty with accounting. Both reading and arithmetic abilities are prerequisites necessary for success in accounting, although Rhodes and Calhoun's research has indicated that reading is the most important.[1] Therefore, an investigation into the readability of introductory accounting textbooks was conducted to determine whether these textbooks have reading levels appropriate for their intended audiences.

A review of literature revealed a dearth of information regarding the readability of collegiate accounting textbooks. Yet, textbooks play a key role in the instructional mode of accounting. For example, Astin found that 86 percent of accounting lectures closely follow the textbook while in other courses of study only 52 percent of the lectures closely follow the textbook.[2] Therefore, it is essential that the purpose of these textbooks — to convey understanding of accounting — should not be stymied by reading levels inappropriate for students.

The purposes of this paper are (1) to remind professors of the importance of readability measurement in the selection of textbooks, (2) to illustrate the application of the Flesch readability formula, and (3) to provide specific readability measures of many current introductory accounting textbooks.

Education

An Analysis of The Readability of Introductory Accounting Textbooks

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Readability

A readability formula is a technique for measuring, in an objective manner, the style difficulty of writing.[3] Of the scores of formulas available, the Flesch is the formula of choice for determining the readability of accounting textbooks. The Flesch is reliable[4] and valid,[5] is statistically superior to other non-word list formulas[6,7] intercorrelates as high as .98 with the Dale-Chall Formula[8] (which requires that all words be checked against a list of basic words), is applicable to technical materials,[9] and is relatively easy[10] to apply in evaluating prospective textbooks. The ease of application is an advantage for practical classroom use.

Although research in the field of readability has clearly established the utility of the Flesch formula, the inherent limitations of readability formulas must be noted. Readability formulas are criticized most often because such formulas do not measure contextual difficulty, abstractness and density of ideas, student interest in a subject, organization, size of type, length of line, spacing, kind of ink and paper,[11] student health, religion, ethnic background, or what the student had for breakfast.[12] Although readability formulas are not perfect, they do provide objective measures of the reading difficulty of textbooks. Professors utilizing a readability formula have a tool for ranking available textbooks in order to match their readability with students' reading ability. If several textbooks meet the objective readability criterion, subjective criteria encompassed in the complete learning system will govern the selection process. On the other hand, if selections have been made, knowledge about the readability of the textbook will help to provide more appropriate instruction. Efforts can be made to compensate for or take advantage of the reading level of the textbook.

Methodology

In order to incorporate the entire pedagogical horizon, twenty-two introductory accounting textbooks intended for the first year of study (except for two one-semester textbooks) were identified and grouped according to primary emphasis: (1) procedural (textbooks which present concepts as well as procedures), (2) conceptual (textbooks which emphasize concepts), and (3) self-learning. Assignment to one of the three categories was made by utilizing one or more of the following criteria: (1) authors' intention as reflected by preface remarks, (2) publishers' communications, and (3) researchers' judgment. Two-volume sequences used for the first year of study were treated as one textbook. For example, *Financial Accounting: An Introduction* by Bierman and Drebin, with nineteen chapters, and *Managerial Accounting: An Introduction* by Drebin and Bierman, with eighteen chapters, were treated as one textbook with thirty-seven chapters. The textbooks are listed in Appendix A.

The Flesch formula which predicts grade level* was deemed most appropriate for the study. Because of the technicalities of constructing the prediction formula and the difficulty in finding criterion reading passages at the college level, the grade level of a particular textbook is somewhat underestimated at adult

TABLE 1

INTRODUCTORY ACCOUNTING TEXTBOOK READABILITY LEVELS*

Flesch Grade Level	Standard Deviation	Textbook Classification		
		Procedural	Conceptual	Self-Learning
9.0	.6	Flesher		
9.4	.6	Tracy		
9.8	.6	Istvan		
9.9	.6			Cashin
10.0	.6	Thacker		
10.0	.8			Pyle
10.1	.5		Davidson	
10.1	.4	Bierman		
10.1	1.0	Woelfel		
10.2	.7			Edwards
10.2	.4	Meigs		
10.3	1.0		Henke	
10.3	.9	Niswonger		
10.3	.6	Reynolds		
10.4	.5		Schattke	
10.6	.8			Margolis
10.7	.3	Walgenbach		
10.7	.2	Pyle		
10.7	1.0		Burns	
10.9	.7	Metcalf		
11.0	1.2	Johnson		
11.3	.5		May	

*Textbooks are referred to by first author. See Appendix A.

levels.[13] This is not considered a serious problem because all textbooks are treated consistently, thus allowing for a meaningful ranking. When interpreting the grade level Flesch scores, it is important to remember the underestimation and to place more emphasis on the ranking. However, the grade level scores were chosen deliberately because they give more information than Flesch's Reading Ease scale which is inverted (lower numbers indicate more difficult reading material) and, for that reason, difficult to interpret.

Readability research has reported that a large number of 100-word passages is appropriate to determine the readability of textbooks.[14] A table of random digits was employed to select five chapters from each textbook. Three 100-word passages were extracted from the first page, the last page, and a middle page of each chapter selected. Thus, each textbook was represented by fifteen 100-word samples which provided a good indication of the reading level of the textbook.

After selection of the fifteen 100-word passages from each textbook was completed, the following counts were made:

1. The number of words to the end of the sentence closest to the end of the 100-word sample — the number could be greater than or less than 100.
2. The number of sentences to the end of the sentence closest to the end of the 100-word sample. Each sentence should have a complete thought, but a sentence could end with a period, with a colon, or with a semicolon.
3. The number of syllables in the 100-word sample.[15]

One investigator did all sampling and counting to ensure the consistent handling of judgment decisions.

A modification was made to the Flesch formula in order to increase its accuracy. The formula specified that the number of syllables in each 100-word sample be counted (step 3). Because of the tedious nature of accurately dividing each word into syllables, counting syllables is the area of greatest error. Therefore, in lieu of counting syllables, letters in each 100-word sample were counted and the letter count was divided by 3.1127 because research has shown that the average syllable is composed of 3.1127 letters. Results obtained using this modification correlate .98 with actual syllable counts.[16,17]

Findings

The Flesch grade level scores for the twenty-two introductory accounting textbooks are reported in Table 1. The grade levels ranged from a low of 9.0 to a high of 11.3. The average score and the median score were 10.3. Because of the progressive nature of the underestimation of grade level for material above the seventh grade,[18] the grade levels probably ranged from 11.0 to 16.0 or from fairly difficult to difficult.

The standard deviation column provides information concerning the readability range within each textbook. For example, at the 95 percent confidence level, the readability of the Flesher and Flesher textbook is from 7.8 to 10.2, while the Johnson and Gentry textbook has a range of 8.6 to 13.4.

Information in Table 1 also reveals that the procedural textbooks ranged from 9.0 to 11.0 and encompassed virtually the entire range. The conceptual textbooks ranged from 10.1 to 11.3 or from the middle to the top of the range except for the Davidson, Schindler, and Weil textbook which, with a readability score of 10.1, demonstrates that conceptual textbooks do not have to be inherently more difficult than procedural textbooks. Three of the four self-learning textbooks have a readability score which is less than the 10.3 median. Therefore, the range for self-learning textbooks is from the low to the middle of the readability range except for the Margolis and Harmon textbook which, with a readability score of 10.6, is enough above the median of all textbooks to question whether self-learning is facilitated.

Recommendations

Differences in the readability of twenty-two introductory accounting textbooks have been presented through the use of the Flesch formula. Professors recognizing the importance of readability measurement can utilize the information when selecting textbooks, planning instruction, and preparing textbooks.

First, because differences exist in the readability of accounting textbooks, this factor merits inclusion as a primary criterion in the textbook adoption decision model. In fact, the objectivity of readability measures could provide an excellent "tie breaker" when other factors such as content appear to be equal. Accounting professors at all levels of collegiate education can utilize objective readability measures in order to match textbooks with students' needs, interests, and abilities.

Second, failure to match textbooks with students may result in the use of textbooks which are too difficult for students and which will require that relatively more time be spent explaining and clarifying basic concepts than would otherwise be necessary. Certainly, the more readable the textbooks to the student, the more helpful it is to the professor. Another instructional advantage of readability measurement is the awareness of parts of a textbook which are more difficult to read. The professor can anticipate whether trouble spots are likely to be the result of reading difficulties or problems with the content.

Finally, the techniques for calculating the Flesch scores presented in the study may be utilized by authors and publishers of textbooks to evaluate a product's readability for particular audiences. For example, self-learning materials might benefit by a significantly lower readability score than textbooks intended for traditional classroom use. Likewise, conceptual textbooks need not be inherently more difficult from a reading standpoint than procedural textbooks.Ω

*Flesch applied regression techniques to develop a formula to predict reading difficulty using word and sentence length as the factors most predictive of comprehension difficulty. The equation for the formula is:

$C_{75} = .0846wl + .1015sl - 5.6835$

where

C_{75} = the average grade of students who could answer three-fourths of the test questions correctly

wl = word length (syllables per 100 words)

sl = sentence length in words

SOURCE: Rudolf Flesch, "A New Readability Yardstick," *Journal of Applied Psychology* 32 (June 1948): 224-225.

NOTES

[1]George S. Rhodes and Calfrey C. Calhoun, "An Investigation of Reading Ability as Related to Successful Study of Beginning Bookkeeping," *National Business Education Quarterly* 35 (March 1967): 22.

[2]Alexander W. Astin, "Classroom Environment in Different Fields of Study," *Journal of Educational Psychology* 56 (October 1965): 278.

[3]George R. Klare, *The Measurement of Readability* (Ames, Iowa: Iowa State University Press, 1963), p. 3.

[4]Patricia M. Hayes, James J. Jenkins, and Bradley J. Walker, "Reliability of the Flesch Readability Formulas," *Journal of Applied Psychology* 34 (February 1950): 26.

[5]Klare, *The Measurement of Readability*, p. 113.

[6]Ibid., p. 71.

[7]R. D. Powers, W. A. Sumner, and B. E. Kearl, "A Recalculation of Four Adult Readability Formulas," *Journal of Educational Psychology* 49 (April 1958): 104.

[8]Klare, *The Measurement of Readability*, pp. 117-118.

[9]John S. Caylor et al., *Methodologies for Determining Reading Requirements of Military Occupational Specialites* (Alexandria, Virginia: Human Resources Research Organization, March 1973), pp. 15-17.

[10]Charles R. Hopkins and Paul Y. Kim, "Textbook Reading Levels," *Business Education Forum* 28 (May 1974): 39.

[11]Allen M. Blair, "Everything You Always Wanted to Know about Readability but Were Afraid to Ask," *Elementary English* 48 (May 1971): 442.

[12]Sylvia-Lee Tibbetts, "How Much Should We Expect Readability Formulas to Do?" *Elementary English* 50 (January 1973): 75.

[13]Rudolf Flesch, "A New Readability Yardstick," *Journal of Applied Psychology* 32 (June 1948): 225.

[14]Mavis Martin, "Refinement of a Readability Formula," *Problems, Programs, and Projects in College-Adult Reading* in *Eleventh Yearbook of the National Reading Conference* (Milwaukee, Wisconsin: The National Reading Conference, Inc., 1962), pp. 136-137.

[15]Rudolf Flesch, *The Art of Readable Writing* (New York: Harper & Brothers, Publishers, 1949), pp. 213-214.

[16]Norman A. Felsenthal and Helen Felsenthal, "Utilizing the Computer to Assess the Readability of Language Samples," paper presented at the meeting of the American Education Research Association, Chicago, 6 April 1972.

[17]G. Wayne Shamo, "Utilizing Readability Formulas to Predict Listenability," paper presented at the meeting of the American Education Research Association, New Orleans, 27 February 1973.

[18]Flesch, "A New Readability Yardstick," p. 225.

APPENDIX A INTRODUCTORY ACCOUNTING TEXTBOOKS*

a Bierman, Harold, Jr., and Drebin, Allan R. *Financial Accounting: An Introduction.* Third Edition. Philadelphia: W. B. Saunders Company, 1978.

Burns, Thomas J., and Hendrickson, Harvey S. *The Accounting Primer: An Introduction to Financial Accounting.* New York: McGraw-Hill Book Company, 1972.

b Cashin, James A., and Lerner, Joel J. *Schaum's Outline of Theory and Problems of Accounting I.* New York: McGraw-Hill Book Company, 1973.

b ________. *Schaum's Outline of Theory and Problems of Accounting II.* New York: McGraw-Hill Book Company, 1974.

Davidson, Sidney; Schindler, James S., and Weil, Roman L. *Fundamentals of Accounting.* Fifth Edition. Hinsdale, Illinois: The Dryden Press, 1975.

[a] Drebin, Allan R., and Bierman, Harold, Jr. *Managerial Accounting: An Introduction*. Third Edition. Philadelphia: W. B. Saunders Company, 1978.

[c] Edwards, James Don, Hermanson, Roger H., and Salmonson, R. F. *Financial Accounting: A Programmed Text*. Fourth Edition. Homewood, Illinois: Richard D. Irwin, Inc., 1978.

[c] ________. *Managerial Accounting: A Programmed Text.* Fourth Edition. Homewood, Illinois: Richard D. Irwin, Inc., 1978.

Flesher, Dale L., and Flesher, Tonya K. *Accounting Principles for Midmanagement.* Albany, New York: Delmar Publishers, 1980.

Henke, Emerson O. *Introduction to Accounting: A Conceptual Approach.* New York: Petrocelli/Charter, 1974.

Istvan, Donald F., and Avery, Clarence G. *Accounting Principles.* New York: Harcourt, Brace, Jovanovich, Inc., 1979.

Johnson, Glenn L., and Gentry, James A., Jr. *Finney and Miller's Principles of Accounting: Introductory.* Seventh Edition. Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1970.

Margolis, Neal, and Harmon, N. Paul. *Accounting Essentials.* New York: John Wiley & Sons, Inc., 1972.

May, Robert G.; Mueller, Gerhard G.; and Williams, Thomas H. *A New Introduction to Financial Accounting.* Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1975.

Meigs, Walter B.; Johnson, Charles E.; and Meigs, Robert F. *Accounting: The Basis for Business Decisions.* Fourth Edition. New York: McGraw-Hill Book Company, 1977.

Metcalf, Richard W., and Titard, Pierre L. *Principles of Accounting.* Philadelphia: W. B. Saunders Company, 1976.

Niswonger, C. Rollin, and Fess, Philip E. *Accounting Principles.* Twelfth Edition. Cincinnati: South-Western Publishing Co., 1977.

[d] Pyle, William W., and Larson, Kermit D. *Programmed Learning Aid for Elementary Accounting: Volume 1.* Revised Edition. Homewood, Illinois: Richard D. Irwin, Inc., Learning Systems Company, 1979.

[d] ________. *Programmed Learning Aid for Elementary Accounting: Volume 2.* Revised Edition. Homewood, Illinois: Richard D. Irwin, Inc., Learning Systems Company, 1979.

Pyle, William W.; White, John Arch; and Larson, Kermit D. *Fundamental Accounting Principles.* Eighth Edition. Homewood, Illinois: Richard D. Irwin, Inc., 1978.

Reynolds, Isaac N.; Slavin, Albert; and Sanders, Allen B. *Elementary Accounting.* Hinsdale, Illinois: The Dryden Press, 1978.

[e] Schattke, Rudolph W., and Jensen, Howard G. *Financial Accounting: Concepts and Uses.* Second Edition. Boston: Allyn and Bacon, Inc., 1978.

[e] Schattke, Rudolph W.; Jensen, Howard G.; and Bean, Virginia L. *Managerial Accounting: Concepts and Uses.* Boston: Allyn and Bacon, Inc., 1974.

Thacker, Ronald J. *Accounting Principles.* Second Edition. Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1979.

[f] Tracy, John A. *Fundamentals of Financial Accounting.* Second Edition. New York: John Wiley & Sons, Inc., 1978.

[f] ________. *Fundamentals of Management Accounting.* New York: John Wiley & Sons, Inc., 1976.

Walgenbach, Paul H.; Dittrich, Norman E.; and Hanson, Ernest I. *Principles of Accounting.* New York: Harcourt, Brace, Jovanovich, Inc., 1976.

Woelfel, Charles J. *Accounting: An Introduction.* Second Edition. Santa Monica, California: Goodyear Publishing Company, Inc., 1977.

*Each set of paired letters was treated as one textbook.

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Auditing Standards Update

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The Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (formerly called the Auditing Standards Executive committee or AudSEC) is responsible for issuing Statements on Auditing Standards (SASs), interpretations of auditing standards and audit guides.

Since this column last reported on new SASs in the January, 1979, issue, nine Statements have been released. Several of these Statements are in response to standards of the Financial Accounting Standards Board or governmental agencies providing expanded disclosures of financial information or of the effectiveness of systems of internal accounting control. Other Statements essentially involve clarification of authority and responsibility for standard setting within the American Institute or are necessary to adapt auditing standards for changes caused by accounting and review services standards for nonpublic entities. Finally, the ASB has issued Statements providing more guidance to auditors on such matters as analytical review procedures and evidential matter.

Official Pronouncements

Following are summaries of seven of the Statements issued from October, 1978 to August, 1980. SASs are effective when issued unless another effective date is specified.

- *SAS No. 23:* The third standard of field work requires that sufficient, competent evidential matter be obtained upon which to base an audit opinion. This evidence is obtained through substantive tests, which consist of "tests of details of transactions and balances and . . . analytical review of significant ratios and trends and resulting investigation of unusual fluctuations and questionable items" (SAS No. 1, section 320.70, before amendment by SAS No. 23).

The purpose of SAS No. 23, "Analytical Review Procedures," is to provide guidance to the auditor regarding the analytical review component of substantive tests. The Statement was issued in October, 1978.

The Statement does not require use of analytical review procedures, but it does indicate the types of analytical review procedures which an auditor may employ and considerations involved in selecting the procedures to be used. The timing of analytical review procedures will vary depending upon the auditor's objective. The extent of analytical review procedures will depend on the nature of the entity, the scope of the engagement, the type and reliability of financial and relevant nonfinancial information available and the type and comparability of industry data available to the auditor. The Statement also discusses factors to be considered in selecting procedures for investigating significant fluctuations disclosed by analytical review procedures.

- *SAS No. 24:* "Review of Interim Financial Information," SAS No. 24, was issued effective for reports on financial information for interim periods ending on or after March 31, 1979. In keeping with the separation of authority within the AICPA for unaudited statements of public and nonpublic entities, SAS No. 24 applies only to reviews of interim financial information of public entities. This Statement supersedes SAS No. 10 dealing with procedures for limited reviews of interim financial information and SAS No. 13 dealing with reports based upon limited reviews.

The nature, timing and extent of the review procedures under Statement No. 24 are essentially the same as those previously required by SAS No. 10. For reviews of public entities, the major effect of the Statement, then, is to replace the two different forms of accountants' reports with a single form of report expressing limited assurance on the interim financial information. The form of the accountant's report is no longer determined by whether the report is intended for use by the board of directors, by stockholders or by regulatory agencies.

The accountants' report should include the following:

- a statement that a review of interim financial information was made in accordance with standards established by the American Institute of Certified Public Accountants,
- an identification of the entity and the financial information reviewed,
- a description of the types of procedures encompassed within a review,
- a statement that a review is substantially less in scope than an audit and that no opinion is expressed on the financial information, and
- a statement whether the accountant is aware of any material modifications which should be made in order for the financial information to be in accordance with

generally accepted accounting principles.

In addition to issuing a report, the accountant is expected to make sure that each page of the interim financial information is marked as "unaudited."

Statement No. 24 provides guidance as to review report modifications required for instances involving financial information materially affected by a departure from generally accepted accounting principles and for cases in which adequate disclosures are not made. The Statement discusses interim information contained in audited financial statements, use of engagement letters, and other related matters while referring the accountant to existing auditing standards for guidance on such matters as subsequent events.

• *SAS No. 25:* In recognition of the AICPA's designation of the Quality Control Standards Committee as the senior technical committee authorized to issue pronouncements on quality control standards, the ASB issued SAS No. 25, "The Relationship of Generally Accepted Auditing Standards to Quality Control Standards," in November, 1979. Statement No. 25 establishes a general requirement that a firm of independent auditors is responsible for establishing quality control policies and procedures which provide reasonable assurance that generally accepted auditing standards are being met.

In adopting a general requirement, SAS No. 25 supersedes SAS No. 4, which had provided nine specific quality control considerations. Concurrent with the ASB action, the Quality Control Standards Committee issued its first statement incorporating the nine considerations of SAS No. 4. Therefore, SAS No. 25 reaffirms that a CPA firm shall have quality control policies and procedures for audits. It also recognizes the authority of the Quality Control Standards Committee to set such standards as they relate to individual audit engagements and to the conduct of the firm's audit practice as a whole.

• *SAS No. 26:* "Association With Financial Statements," SAS No. 26, was issued in November, 1979. Statement No. 26 became necessary to update auditing standards for changes caused by separate standards for accounting and review service engagements of nonpublic entities. Essentially, this Statement reaffirms prior understanding of instances in which an accountant is considered to be associated with financial statements. Statement No. 26 provides that the disclaimer of opinion report remains unchanged for unaudited financial statements of public entities. Examples are provided for disclaimers of opinion when the unaudited financial statements of a public entity are presented on a comprehensive basis of accounting other than generally accepted accounting principles, for cases in which the accountant is not independent with respect to the public entity, and for presentations of unaudited and audited financial statements in comparative form.

This Statement applies to public entities unless specifically excepted by another SAS and to nonpublic entities when the accountant has been engaged to examine the financial information in accordance with generally accepted auditing standards. SAS No. 26 refers the accountant to Statements on Standards for Accounting and Review Services for guidance in instances involving nonaudit services for nonpublic entities.

SAS No. 26 provides that the accountant may give expressions of negative assurance only in those instances specifically recognized as acceptable by standards established by the AICPA, such as letters for underwriters.

• *SAS No. 27 & No. 28:* One approach used by the Financial Accounting Standards Board and the Securities and Exhange Commission in recent years to deal with the problem of furnishing desirable financial information to investors and other users has been to require that certain additional types of information be furnished outside of the financial statements. SAS No. 27, "Supplementary Information Required by the Financial Accounting Standards Board," and SAS No. 28, "Supplementary Information on the Effects of Changing Prices," have been issued to provide guidance to auditors of companies furnishing this information outside the financial statements. SAS No. 27 is effective for examinations of financial statements for periods ending after December 24, 1979.

Statement No. 27 specifies certain limited procedures which the auditor should apply to supplementary information required by the Financial Accounting Standards Board. These procedures include inquiries of management regarding the methods used in preparing the information; comparison of the information for consistency with responses; comparison of the information for consistency with responses of management responses in the written representation letter; application of procedures required by other SASs; and specific inquiries regarding any information which the auditor, as a result of the procedure above, believes may not be measured or presented properly.

The auditor's report need not refer to the supplementary disclosures unless required supplementary information is omitted, unless the auditor believes that the supplementary information materially departs from Financial Accounting Standards Board requirements, or unless the auditor is not able to complete the procedures specified. The auditor should make sure that each page of the supplementary information is marked "unaudited."

SAS No. 28, which was issued in June, 1980, expands the guidance of SAS No. 27 as to specific inquiries of management regarding management judgements made concerning measurement and presentation of supplementary information on the effects of changing prices which are included in the financial reports and to compare these explanations and discussions for consistency with the audited financial statements and supplementary information on the effects of changing prices.

As with SAS No. 27, Statement No. 28 requires the audit report be expanded to refer to supplementary information on the effects of changing prices if the management narrative included in the financial reports contains a material misstatement of fact or if it is not consistent with the financial statements or other supplementary financial information.

Statements No. 27 and No. 28 must be read along with SAS No. 8 and No. 29 to fully interpret the auditor's reporting responsibilities in varying circumstances discussed.

• *SAS No. 29:* Statements No. 27 and No. 28 deal with audit procedures and reporting for certain supplementary information outside the financial statements which is included in *client-prepared* documents. SAS No. 8 discusses the auditor's responsibilities when the audit report is included in *client-prepared* documents which contain other unaudited information. In contrast, SAS No. 29, "Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents," provides guidance on reporting when the *auditor submits* a document containing audited or unaudited data in addition to the basic financial statements. Statement No. 29 supersedes SAS No. 1, section 610, on long-form reports and is effective for audit reports dated after December 30, 1980.

Statement No. 29 makes it clear that the auditor's reporting objective in cases involving information accompanying the basic financial statements in an auditor-submitted document is to describe the character of the auditor's examination of this information and the degree of responsibility, if any, which the auditor is taking for the accompanying information. Specifically, the report should indicate the following:

- that the purpose of the examination was to form an opinion on the basic financial statements taken as a whole,
- an identification by title or, perhaps, by page number of the accompanying information,
- that the accompanying information is presented for purposes of additional analysis and that it is not a required part of the basic financial statements, and
- either an opinion on whether the accompanying information is fairly stated in all material respects in relation to the financial statements taken as a whole or a disclaimer of opinion on the accompanying information.

SAS No. 29 provides examples of reports which may be used and gives additional guidance to the auditor in certain special circumstances. The examples include an audited supplementary information report, a disclaimer report on all of the supplementary information, a disclaimer report on part of the supplementary information, a qualified report, and an opinion on supplementary consolidating information.

Reporting under SAS No. 27 is modified to the extent that the auditor must specifically report on any supplementary information required by the FASB if the information is to be included in an auditor-submitted document. Ω

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